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**LOCAL DEVELOPMENT PAPER NO. 8**

# Equity Capital and Economic Development in Newfoundland and Labrador

by

Economic Council of Newfoundland
and Labrador

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## Résumé

Les méthodes actuelles visant l'expansion économique mettent surtout l'accent sur l'incitation des entrepreneurs et la stimulation des entreprises comme moyens d'autodéveloppement. A Terre-Neuve, les petites et moyennes entreprises (PME) pourraient, en tant qu'éléments d'une stratégie équilibrée d'expansion économique, faire beaucoup pour rapprocher l'économie provinciale de cet objectif. Cependant, un des besoins premiers de l'expansion des PME nouvelles ou existantes est le capital de risque. Avec cette étude, nous sommes les premiers à tenter de cerner et d'analyser le marché du capital de risque à Terre-Neuve, et d'examiner et recommander des mesures pour y stimuler l'offre et la demande.

Malgré la rareté des données quantitatives sur le besoin ou la demande de capital de risque à Terre-Neuve, on estime généralement que le marché du capital de risque est limité. Il y a à cela deux raisons : 1) l'économie est fragile et dépend du gouvernement, il est donc difficile d'attirer ou de retenir les investissements; et 2) la plupart des entreprises de la province sont de petite taille, oeuvrant dans le secteur des services et exploitées par leurs propriétaires qui connaissent mal le modèle de la copropriété ainsi que le besoin et le rôle des capitaux externes.

La demande de capitaux se limite donc à un petit noyau du secteur des affaires, lequel toutefois prend actuellement de l'ampleur. Une catégorisation plus détaillée de la demande actuelle du marché comprendrait : 1) un faible pourcentage de sociétés nouvelles ou en place qui souffrent de sous-capitalisation, et 2) de nouvelles sociétés productrices de biens et services de haute technologie, qui représentent un pourcentage encore plus faible du secteur des affaires. Malheureusement, les sociétés qui ont besoin de capitaux, mais qui ne savent pas comment recourir au marché, ne peuvent pas en recevoir; même celles qui le font essuient souvent un refus parce que bon nombre d'entre elles ne possèdent ni un projet commercial détaillé ni les compétences en gestion et l'expérience des affaires nécessaires, montrant ainsi qu'elles comprennent mal le rôle des capitaux dans une entreprise. Il en est d'autres qui possèdent les compétences et l'expérience requises, mais qui se voient refuser leur demande parce qu'elles ne s'entendent pas avec les prêteurs sur les montants nécessaires ou sur d'autres questions commerciales.

Le côté demande de l'équation est donc plutôt faible et peu développé à Terre-Neuve. L'ajustement de l'offre prendra ainsi du temps et il faudra faire des efforts considérables pour améliorer la qualité et la quantité de la demande. Pour ce faire, les gouvernements fédéral et provincial devront tous deux jouer un rôle actif et important. L'amélioration de la qualité de la demande requiert une meilleure coordination des cours de formation en gestion et des services de consultation qui sont actuellement offerts. Ces cours et services doivent être à la fois flexibles et accessibles. Mais dans les cas où de futurs entrepreneurs demandent de l'aide financière du gouvernement et que leur compétence et leur expérience s'avèrent inadéquates, la formation et les services de consultation devraient être des prérequis au consentement de fonds. Aussi, il faudrait mettre des fonds limités à la disposition des entrepreneurs pour leur permettre de réaliser des études de faisabilité et d'élaborer des projets d'affaires. L'augmentation de la demande requiert l'incorporation des principes de l'entrepreneurship dans tous les programmes offerts dans nos collèges communautaires et nos écoles techniques et dans un plus grand nombre de cours de l'Université Memorial. Mais même dans le système scolaire général de la province, les principes de l'entrepreneurship devraient être enseignés aux étudiants.

Le problème fondamental du côté offre de l'équation est qu'à l'heure actuelle seul un petit nombre de sources publiques et privées assurent des fonds. Cette situation n'a rien d'étonnant vu l'état actuel de la demande dans la province, mais elle constitue un sérieux problème, et pour plusieurs raisons. Premièrement, il n'existe pas de véritable concurrence entre les fournisseurs. L'expérience des autres provinces montre que l'efficacité des capitaux est fonction de l'importance des réserves et du nombre des fournisseurs ou bailleurs de fonds dans les régions visées. Deuxièmement, les fournisseurs locaux de capital de risque ne peuvent, faute de ressources, assurer un grand nombre de projets ou d'investissements. Troisièmement, il existe souvent des incompatibilités entre ceux qui possèdent les capitaux et ceux qui en auraient besoin. Le plus grand problème est que les entreprises dont les gestionnaires manquent d'expérience intéressent naturellement peu le secteur privé. Mais d'autres facteurs contribuent également à ces incompatibilités; par exemple, la plupart des entreprises de la

province ont des besoins restreints de capitaux, moins de 100 000 $, alors que les sociétés de capital-risque cherchent généralement à faire de plus gros placements. Ou encore, les besoins de capitaux dépassent les ressources des fournisseurs locaux de capital de risque, dans le cas, par exemple, d'entreprises de haute technologie. Un autre facteur est la divergence des intérêts commerciaux : certaines sociétés de capital de risque ont décidé par exemple de limiter leur champ d'action à certains secteurs et refusent -- nonobstant la valeur intrinsèque d'une proposition -- de sortir des limites qu'elles se sont fixées.

Les fournisseurs des secteurs public ou privé ne répondent pas pleinement aux besoins ou aux demandes des entreprises locales. Il s'agit d'un autre domaine où les gouvernements fédéral et provincial devront jouer un rôle actif. Les entreprises qui manquent d'expérience et qui ont des besoins restreints de capitaux devraient jouir non seulement des services de formation en gestion et de consultation mentionnés ci-haut, mais aussi d'un accès plus facile aux sources publiques de capital de risque en attendant qu'elles atteignent le degré de maturité qui les rendra plus intéressantes aux yeux des prêteurs privés. Plutôt que de concurrencer le secteur privé, les deux paliers de gouvernement devraient chercher à le compléter en consacrant surtout leurs
ressources à satisfaire les demandes de capitaux de moins de 100 000 $. En même temps, il faudrait multiplier les efforts pour accroître le nombre des bailleurs de fonds et fournisseurs privés de la région, surtout parce que le marché existant est incapable de répondre aux demandes de certaines sociétés locales qui réclament des capitaux relativement importants. Ironie du sort, l'épargne et l'investissement constituent de grandes réserves de capitaux dont la presque totalité sort de la province. Il faudrait faire appel à ces fonds, qui se chiffrent au bas mot à 350 millions de dollars par an, et en réserver une part à l'expansion économique. Il existe deux moyens d'y arriver. Premièrement, il y a les mécanismes qui incitent les détenteurs de capitaux à investir dans des entreprises locales et leur en fournissent l'occasion. A cet égard, il faut se réjouir de l'instauration en mai dernier du Newfoundland Stock Savings Program et du Venture Capital Tax Credit Program. Mais d'autres mesures fiscales s'offrent aussi aux gouvernements fédéral et provincial; par exemple, pour encourager l'investissement par les travailleurs dans des entreprises terreneuviennes, le gouvernement provincial devrait étudier la possibilité d'offrir un crédit d'impôt correspondant au crédit fédéral actuel. Ensuite, une partie de cet argent, qui se retrouve surtout dans les fonds de pensions (particulièrement le Pooled Pension Fund of the Province of Newfoundland), pourrait servir à des fins plus productives. Au Canada et dans d'autres pays, les fonds de pension servent de plus en plus de capital de risque pour soutenir l'expansion économique; voilà pourquoi nous recommandons à la Province d'employer une partie de son fonds de pension pour l'investissement direct dans des entreprises de Terre-Neuve et pour financer certaines des initiatives d'offre et de demande mentionnées ci-haut.

Manifestement, toute amélioration de la qualité et de la quantité de la demande et tout accroissement de l'offre de capital de risque locale contribueront à rendre le milieu plus favorable aux entrepreneurs et à l'entreprise, à renforcer les PME, à leur permettre de croître et à assurer une plus grande expansion économique de la province.

## ABSTRACT

Current approaches to economic development are placing more emphasis on the encouragement of entrepreneurship and stimulation of enterprise as a means to achieve self-reliance. In Newfoundland, small- and medium-sized enterprises (SMEs), as part of a balanced economic development strategy, can play an important role in moving the provincial economy toward this objective. However, one of the key requirements for the development of new and existing SMEs is equity capital. This study is the first attempt to identify and analyze the market for equity capital in Newfoundland and to discuss and recommend measures to stimulate demand and supply.

While quantitative information on either the need or demand for equity capital in Newfoundland is scanty, it is widely held that the market for equity capital is small. There are at least two reasons for this: (1) the economy is vulnerable and dependent upon government, and this makes it difficult to attract or retain investment, and (2) most businesses in the province are small, owner-operated establishments in the service sector and, therefore, have limited experience with shared ownership and a low need and appreciation of the role of outside equity.

Consequently, demand for equity is limited to a small, though growing, sector of the business community. More specifically, current market demand can be classified to include: (1) a small percentage of new and existing under-capitalized companies, and (2) new and emerging high-technology services and product manufacturing companies, which represent an even smaller percentage of the business community. Unfortunately, those who need equity but do not come to the market will not get it; however, even those who do come to the market are often unsuccessful. This is because many who need or demand equity capital lack a well-defined business plan, associated management skills and business experience, and an understanding of the role of equity in an enterprise. Yet there are others with the required skills and experience who, because of differences with suppliers about the amount of capital being sought and/or different areas of business interest, are often unsuccessful as well.

Thus, the demand side of the equation is generally weak and poorly developed in Newfoundland. As a result, supply-side adjustments will be slow to take place and, consequently, considerable effort must now be directed to improving the quality and increasing the quantity of the demand side. This will require both the federal and provincial governments to take a strong, pro-active role. To improve the quality of the demand, business-skills training and counselling services must be offered in a more coordinated manner than at present. Courses and counselling services must be both flexible and accessible. Moreover, when prospective entrepreneurs are applying for government financial assistance, training and counselling services should be made a condition of approval in cases where the applicants' skills and experience are deficient. Also, small amounts of capital must be made available to assist entrepreneurs to conduct feasibility studies and develop business plans. To improve the quantity of the demand, the principles of entrepreneurship should be included in all programs in our community colleges and technical schools and should be more widely available in programs at Memorial University of Newfoundland. In addition, the Province's school system should also introduce students to the principles of entrepreneurship and provide the option to take a course in this area.

The fundamental problem with the supply side of the equation is that supplies are limited to a few public and private sources at present. This should come as no surprise given the present state of demand in the Province, and this is a serious problem for a number of reasons. First, there is effectively no competition among suppliers. The experiences of other provinces demonstrate that, to be effective, the available pools of capital should be large and the sources, or venture capitalists, should be both numerous and indigenous to the respective regions. Secondly, the local venture-capital community cannot manage a large number of projects or investments, simply because they do not have the resources to do so. Thirdly, there are often incompatibilities between those with capital and those seeking it. The biggest problem here is that firms without experienced management are, understandably, of little interest to the the private sector. But, there are other factors which also result in incompatibilities; for example, most firms in the Province are looking for relatively small amounts of capital, less than $100,000, whereas most venture-capital companies are looking to make larger investments, or alternatively, the amount of capital being sought is too large for the local venture-capital community to supply, as is the case with some high-tech ventures. Another factor is having differing areas of business interest. For example, some local venture-capital companies have decided to limit their areas of interest to a few sectors, and if they are approached

by someone with a project that falls outside these sectors, there will be no deal, regardless of how good the proposal is.

Neither public nor private sector supply sources are meeting fully the needs or demands of local companies. This is also an area that will require the federal and provincial governments to adopt a pro-active development role. Companies which lack experience and do not need large amounts of capital will require not only the business training and counselling services cited above, but also more liberal and generous access to equity financing from public sources until they reach a level of maturity where they are attractive to the private venture-capital market. Rather than compete with the private sector, both governments should complement the private sector by focusing their resources on supplying the low end of the equity market for amounts less than $100,000.00. At the same time, efforts must focus on increasing the number of indigenous private venture capitalists and sources of supply, particularly because the existing market is unable to meet the requirements of some local companies who need relatively larger amounts of capital. Ironically, there are large pools of capital in various savings and investments, almost all of which flow out of the Province. Some of this money, the total of which is at least $350 million a year, must be tapped and directed to economic development. This can be done in two ways. First, mechanisms can be made available to provide those with capital the option and incentive to invest in local enterprises. In this regard, both the Newfoundland Stock Savings Program and the Venture Capital Tax Credit Program, which were introduced in May of this year, are to be commended. However, there are other tax-based measures that both the federal and provincial governments can consider as well; for example, to encourage the investment of labour-sponsored venture capital in Newfoundland enterprises the provincial government should investigate an income tax credit to match the existing federal incentive. Secondly, some of this money, the majority of which is pension funds (in particular the Pooled Pension Fund of the Province of Newfoundland) can be used more creatively. Following the growing trend in Canada and other countries to use pension funds for venture capital and for economic development, it is recommended that the Province use part of its pension fund for direct investments in Newfoundland-based companies, and for financing some of the demand and supply initiatives mentioned above.

If efforts to improve the quality and quantity of demand and develop more indigenous supplies of equity capital are successful, they will build a favourable environment for entrepreneurs and enterprise. This will lead to a strengthening and growth of SMEs in the Province and will make a major contribution to economic development.

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## FOREWORD

The purpose of the Economic Council's project on Directions for Regional Development was to look at situations in which local communities had assumed more responsibility for their own development, and to see what lessons could be learned from these experiences. Fourteen case studies were undertaken, while a number of Issue Papers examined subjects of general concern to communities and development practitioners. The research was deliberately designed to be different from work typically undertaken by the Council in the past. The primary task was to collect instructive evidence, and to verify it where possible by drawing upon existing evaluation studies. The authors were not expected, for example, to undertake the extensive data collection needed to do cost-benefit studies. Rather, they were asked to capture the diversity of the local development experience in Canada.

The results of the research are being reported in a special collection of Local Development Papers. The first seven releases in the collection are listed at the end of this document. Further papers addressing the problems of single industry towns, urban cores, development indicators and other cases and aspects of local development will be released over the next few months and an overview of the findings from these cases and Issue Papers will be presented in a paper entitled Developing Communities: The Local Development Experience in Canada.

A subsequent phase of the project will analyze the context within which local development initiatives take place and evaluate their actual and potential impact on reducing regional disparities.

This Paper presents one of the Issue Papers produced by the Directions for Regional Development project under the direction of Dal Brodhead.

Like the case studies, these issue papers arose out of the project team's research and consultations with community development workers, government officials, women's groups, business people, non-profit organizations, and many others across Canada. A unique feature of the project was its regional orientation through the use of three regional consultants who played a major role in the development of the case studies and issue papers and in the consultation process. Equally important were the numerous joint research ventures undertaken with a wide range of regionally-based partners.

Among the most fruitful of these partnerships has been the one with the Economic Council of Newfoundland and Labrador, with whom the Economic Council of Canada is now jointly publishing the present study on equity capital mobilization in Newfoundland and Labrador. The Economic Council of Newfoundland and Labrador is a provincial crown corporation which was established in 1983 to provide independent and responsible advice to the provincial cabinet. The organization's mandate is to identify the major social and economic issues facing the province, advise on policies and strategies to address these issues, and contribute to informed public debate.

Sharing with the Economic Council of Canada a common interest in exploring innovative policy options for regional development, especially options that encourage entrepreneurship and enterprise, the Economic Council of Newfoundland and Labrador agreed in January 1988 to undertake a study on the issue of equity capital, with emphasis on constraints and opportunities for mobilizing equity capital for economic development in Newfoundland and Labrador. This report was originally published by the Economic Council of Newfoundland and Labrador in November 1988; consequently, the data contained in the report are current to that date only.

This report was written by Paul Bugden, Executive Director, and Adele Poynter, Director of Research, with research assistance from Anthony McLevey, Economist.

Judith Maxwell
Chairman

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## CHAPTER 1: INTRODUCTION

Regional economic disparities in Canada have persisted for many years, and the problem of how to address this issue has puzzled and frustrated many policy-makers and economic planners at the national and provincial levels. Nowhere has this problem been more acute than in Atlantic Canada, particularly Newfoundland and Labrador.

When Newfoundland joined Canada in 1949, there were great expectations that Confederation would bring major improvements in social services and economic prosperity. In the social services area, the Province has experienced major improvements in education, health care and income support programs. Confederation has also brought about improved economic circumstances but, despite the efforts of federal and provincial governments over almost 40 years, the need to broaden and diversify the Newfoundland economy is as great in 1988 as it was in 1949.

While there have been periods of strong economic growth, the provincial economy is still small, open and vulnerable because of its dependence on exports of largely unprocessed natural resources. While this situation is cushioned somewhat by the availability of federal transfer payments, a high dependency on the federal government for transfer payments to individuals and to the provincial government is undesirable to people in Newfoundland and the rest of Canada. Current efforts, therefore, must focus on expanding the Province's economic base in order to increase employment and income and to provide greater economic stability. To put it simply, and to paraphrase the Economic Council of Canada, policy initiatives must focus on moving Newfoundland from dependency to self-reliance .

The 1986 Provincial Royal Commission on Employment and Unemployment also had self-reliance as a central theme and found that small and medium-sized enterprises, SMEs[1], as part of a balanced economic development strategy, can play a major role in bringing about this economic transformation.[2] However, if SMEs are to play this role, conditions conducive to their development must exist. One of the most persistent and pressing problems preventing SME formation and development in underdeveloped regions like Newfoundland is lack of equity capital, i.e., under-capitalization.

Consequently, this study examines the market for equity capital in Newfoundland and discusses the importance of equity capital in fostering the growth of new and existing SMEs in the province.[3] Chapter 2 addresses the need for equity capital and describes the demand side of the market. Chapter 3 examines the supply side of the market through a discussion of both existing and potential supplies of equity capital in Newfoundland. Chapter 4 provides an assessment of both demand and supply, and discusses

initiatives and mechanisms to stimulate both. Chapter 5 gives the study's conclusions and proposes recommendations for consideration by both the public and private sectors.

## Notes

1 The Statistics Canada (Catalogue 61-231) definition of small business is used here and includes businesses with more than $10,000 and less than $2,000,000 in annual gross revenue. Excluded from the definition are economic units engaged in farming and fishing, professional services, commission sales, and unincorporated rental operations (where rental income is not a major source of revenue for the operation).

2 Royal Commission on Employment and Unemployment, Building On Our Strengths, 1986, p. 400.

3 The term "equity" is used here to mean total assets and liabilities. The term "equity financing" in this study refers to equity investment that originates from outside or external investors. Although other monies, such as retained earnings, for example, can be significant sources of equity capital, only outside sources are considered.

## CHAPTER 2: DEMAND FOR OUTSIDE EQUITY FINANCING

### 2.1 The Need for Equity Capital

Information collected for this and other studies indicates that under-capitalization is a problem for businesses in Newfoundland. One aspect of this problem is the need for equity capital to reduce the probability of business failure stemming from an inadequate equity base. Another aspect which is increasingly prominent is the need for equity capital to finance new ventures and to facilitate the growth of established businesses.

Highly leveraged businesses, those incorporating a high degree of total debt relative to total assets, face a greater probability of failure than those with a strong equity base. Moreover, debt servicing costs can seriously reduce the flexibility of an owner/manager to make investment and operating decisions. The relative indebtedness of SMEs in Atlantic Canada indicates a need to strengthen their capital structure to enable them to take more flexible management decisions and to make the enterprises more resilient to severe economic downturns.[1]

The dangers associated with a weak equity base are reflected in bankruptcy statistics from the most recent recession in Canada, 1981-82. A report of the Small Business Branch of the Ontario Ministry of Industry, Trade and Technology, for example, notes that the recession made quite apparent the shortage of equity in the capital structure of Canadian small businesses: bankruptcies reached new heights in 1981 and 1982 and, although interest rates were a contributing factor, research indicates "excessive debt was a common cause and high interest rates were more a symptom than an actual problem".[2]

Bankruptcy statistics for Newfoundland, shown in Figure 1, also reveal an increase in bankruptcies in this province in the wake of the 1981-82 recession. These statistics suggest that there were many firms in Newfoundland, as in Canada, who would have benefited from an injection of equity capital at that time. Undoubtedly, the problem of debt-loading still persists today; however, there is also growing evidence that there is an increasing number of firms in this province who require, and want, equity to finance start-up and/or expansion. In addition, an adequate equity base is often a requirement for accessing other forms of financial assistance from public or private sources.

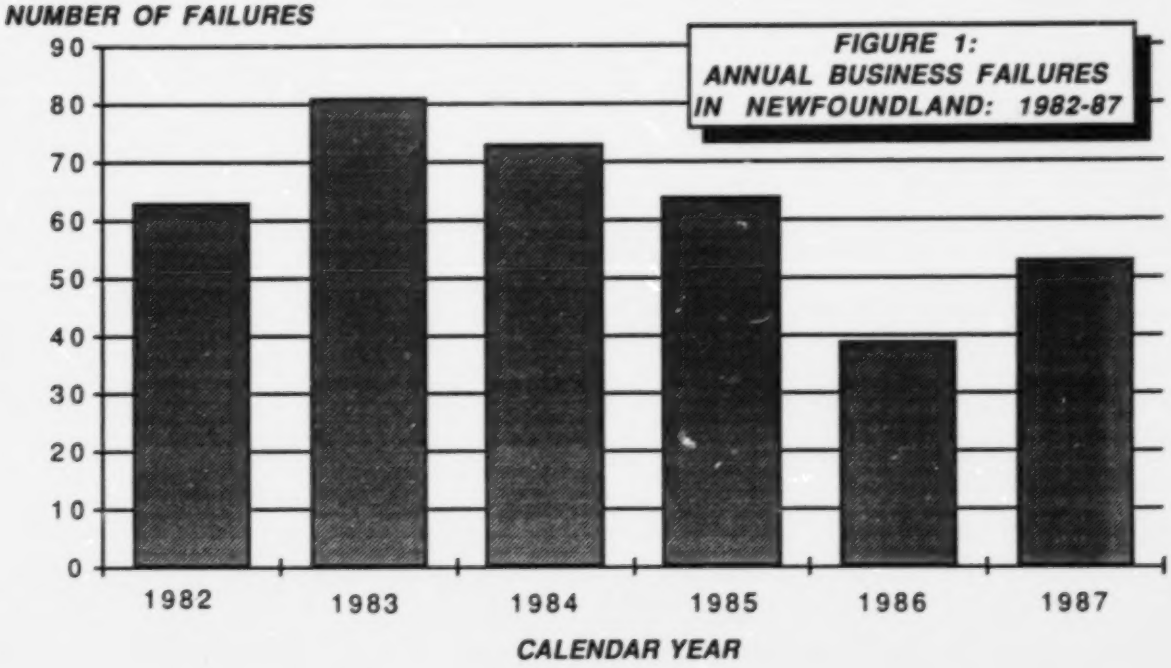



**FIGURE 1: ANNUAL BUSINESS FAILURES IN NEWFOUNDLAND: 1982-87**

Source: Consumer and Corporate Affairs Canada, Office of the Superintendent of Bankruptcy, Insolvency Bulletin, Annual Statistical Summaries, 1982-87.

Unfortunately, it is difficult to determine how this need for equity capital is being translated into demand in this province. There are no data on the extent or nature of the need or demand for equity capital by businesses in Newfoundland. However, need or demand is influenced by such factors as the structure of the economy and the nature of the business community, and the effect of these variables is discussed in the balance of this chapter.

## 2.2 Factors Influencing Demand

### 2.2.1 Economic Structure and Performance

The Newfoundland economy can best be described as primary-resource-based and export-oriented. Today, as in the past, the harvesting and processing of fish and timber, along with extraction of minerals,

form the cornerstone of the provincial economy. Furthermore, almost all the fish and fish products, newsprint, and minerals produced is exported to foreign markets, principally the United States.

In 1986, these resources were the base for 19.3 per cent of provincial Gross Domestic Product (GDP). In fact, 66.9 per cent of manufacturing GDP was fish processing and pulp and paper manufacturing, while non-resource related manufacturing accounted for only 3.4 per cent of GDP. This illustrates the economy's dependence upon a few primary resources and shows that there is a limited secondary manufacturing base. As a result, the provincial economy's annual economic prospects are strongly influenced by international commodity prices and other factors such as trade barriers, areas which are outside the Province's control. This narrow base and lack of diversity, coupled with the seasonal nature of several of these primary industries, notably the inshore fishery, has contributed to high unemployment rates and low per capita earned incomes.

However, while the provincial economy is quite vulnerable, this situation is cushioned somewhat by the availability of federal transfer payments. For example, in 1986 federal transfer payments to individuals constituted 29 per cent of personal income, and it is estimated that total federal transfers during 1987-88 contributed 49 per cent to provincial government revenue. As a result, per capita personal income is much higher than would be the case otherwise, and the provincial government is able to provide more and better-quality services than would be possible otherwise. Consequently, the provincial economy has a relatively well-developed service sector, and its structure and contribution to GDP, 61.2 per cent in 1986, is consistent with other Canadian provinces.

The performance of the provincial economy was hard hit by the recession of the early 1980s. In constant dollar terms, GDP declined by 0.5 per cent between 1981 and 1982, and the provincial unemployment rate went from 13.9 per cent in 1981 to a peak of 21.3 per cent in 1985. This compares with a national unemployment rate of 7.5 per cent in 1981, which peaked at 11.9 per cent in 1983. In Newfoundland, recovery from the recession has taken longer than for the nation as a whole. The Province's GDP in constant dollar terms showed an average annual increase of 2.8 per cent between 1983 and 1987, and is expected to increase between 2.0 and 2.5 per cent in 1988. The unemployment rate in Newfoundland declined to 18.6 per cent in 1987, and may show a further slight reduction in 1988. While these trends are certainly encouraging for Newfoundland, they look less favorable when compared to the national situation. For Canada as a whole, average annual GDP growth was 4.5 per cent between 1983 and 1987, and growth in 1988 is expected to match this performance. Nationally, the unemployment rate declined to 8.9 per cent in 1987, and is showing signs of further decline in 1988. In comparative terms, the Province's GDP growth rate is only about 50 per cent of the national average, and the provincial unemployment rate is still more than double the national average. This poorer performance is reflected in two other important

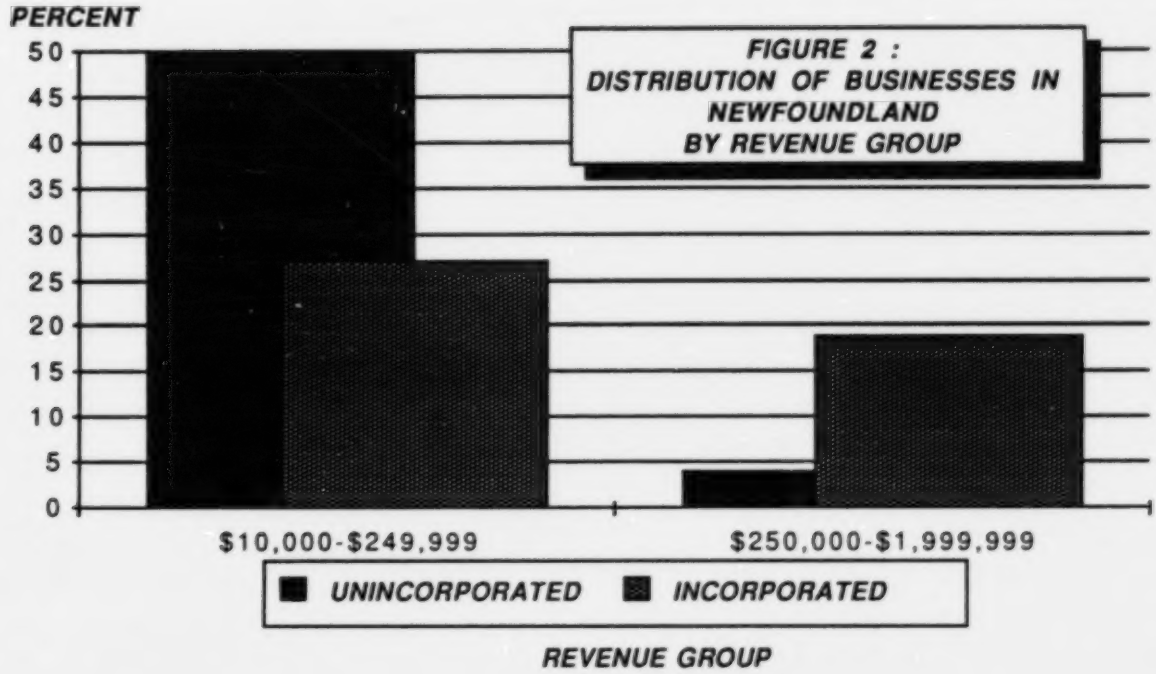
indicators. In 1987, real GDP per capita in Newfoundland was just 50 per cent of the national level, and real personal income per capita in Newfoundland was only 70 per cent of the national level.

In summary, because the Newfoundland economy is small, open and therefore vulnerable, and because it has a heavy dependency upon federal transfer payments to government and individuals, it is difficult either to attract or retain investment.

### 2.2.2 Nature of the Business Community

Statistics Canada estimates there were 10,860 SMEs operating in Newfoundland in 1985, and these represented in excess of 95 per cent of total businesses in the Province. Slightly more than 80 per cent of SMEs were in service industries, 18.7 per cent were in the manufacturing sector, and only 1 per cent in primary industries. Figure 2 illustrates the distribution of SMEs by revenue group. Seventy-six per cent of SMEs in the Province during 1984 had annual revenues between $10,000 and $249,999. Most of these were unincorporated businesses, which clearly indicates that a very large proportion of the Province's business community is made up of proprietorships or partnerships with relatively low sales levels.

From this brief overview, it is obvious that one of the most salient features of the Province's business community is the dominance of relatively small service-sector businesses in the economy. The findings of a business survey conducted in the United States in 1986 showed that, in general, service sector businesses have low capital requirements, and businesses with low capital requirements tend to maintain a high level of ownership and control by their original owners. The survey results also showed that owners of service businesses, especially wholesale and retail operations, which are particularly important in the Newfoundland context, were "twice as likely to own 100 per cent of their companies as are those in financial businesses, and three times as likely as those involved in high-tech and manufacturing companies - in only 18 per cent of these capital intensive companies could the owner claim the company was totally his or hers".[3] These findings suggest that a high percentage of original owners of businesses in Newfoundland have all or a controlling interest in their businesses and have a low demand for outside equity.




Source: Statistics Canada, Canadian Business: A Financial Summary (Newfoundland,1985), Small Business and Special Surveys, March 1988.

## 2.3 Characteristics of Demand

The structure and performance of the provincial economy and the nature and characteristics of the business community have important implications for the demand for outside equity financing in Newfoundland.

As discussed earlier, the provincial economy is small, open and vulnerable, and this vulnerability became quite clear during the recession. From the point of view of an individual considering starting a business, or an investor seeking new opportunities, the economy's small size and vulnerability add additional elements of risk to the decision-making process. Consequently, prospective entrepreneurs may decide not to start their own businesses. Similarly, investors who are averse to risk will be very discriminating when choosing

businesses in which to invest, and they may require a greater controlling interest in the business as a means of offsetting the greater risk. Such a demand may be unacceptable to the entrepreneur. Alternatively, investors may choose to place their money elsewhere. Ironically, one of the features of the Newfoundland economy, federal transfer payments, that to some degree offsets this risk, contributes little to investor confidence because many investors see the economy as being not only small and vulnerable, but also dependent upon government. Collectively, these features are viewed as impediments to investment and entrepreneurship. In fact, it can be argued that the economy's dependency in particular has stymied entrepreneurship and, therefore, retarded the demand for equity capital.

The fact that most existing businesses in the Province are small, owner-operated establishments in the service sector has also limited the demand for outside equity capital, particularly for expansion or financial restructuring purposes. Many of these businesses are moulded to fit the lifestyle of the owner; they have relatively low capital requirements, cater largely to the local market, and have relatively low earning potential. Most of these are unlikely prospects for injections of outside equity investment. Moreover, the owners generally want to maintain control of their business rather than losing flexibility and freedom to an outside equity investor. For this reason, as A. Gadbois notes, the business community in Atlantic Canada, and Newfoundland in particular, has a limited tradition of shared ownership.[4] As a result, there is a tendency for business people to rely on debt financing as long as it is available. Gadbois ascribes this to a generally "low level of appreciation for the role of equity-related capital in the financing structure of their enterprise".[5] This preference for debt extends to include reliance on personal equity and loans from relatives and friends, particularly during the early stages of development.[6] For example, the results of the U.S. survey, cited in 2.2.2 above, highlight the use of money from family and friends, retained earnings and the personal savings of the owner/manager to finance business operations. The results showed 34 per cent of respondents had made start-up loans to their company. This is equity that is shown as a liability on company records. Other owners leased assets to the company, recording this as debt. Under these conditions the debt burden is not as heavy as official business records would show.

Overall, the structure and performance of the economy and the characteristics of the business community suggest that demand for outside equity will be generally low. It is likely that only a small percentage of SMEs in Newfoundland will seek outside equity financing and only a few will attract it. Therefore, at present, market demand can be classified in the following broad categories made up of: (1) a small percentage of new and existing SMEs; and (2) new and emerging high-technology services and product manufacturing companies which represent an even smaller percentage of businesses in the Province. However, research conducted for this study suggests that this market demand is growing slowly, and that the need for equity capital is much more widespread.

Those who need equity but do not come to the market will not succeed in obtaining it, although even those who do come to the market are often unsuccessful. In part, this is because of supply-side problems, which will be discussed in the following chapter. But a major reason is inadequacies on the demand side: those who need and/or demand equity capital often lack a well-defined business plan, management skills, business experience and an understanding of the role of outside equity in an enterprise. While this need or demand remains unsophisticated and not effectively expressed in the market, supply-side adjustments to make equity available and accessible will be slow to take place. In time, this could seriously impede economic growth and development in the Province. Measures are needed to improve the quality and increase the quantity of demand.

## Notes

1 A. Gadbois, Venture Capital Financing in New Brunswick: A Discussion Paper, prepared for the Economic Council of Canada (unpublished), April 1988, p. 34.

2 D. A. Whyte, "Financing Small Business: When Interest Rates Become a Burden," Journal of Small Business Canada, Vol. 1, No. 2, Fall 1983, p.14.

3 M.F. Pollock and J.C. Pollock, "The Venture Survey: Financing Your Own Business", Venture, October 1986, p. 24.

4 Gadbois, p. 35.

5 Gadbois, p. 38.

6 See, for example, R.M. Knight, "The Financing of Small High-Technology Firms in Canada", Journal of Small Business and Entrepreneurship, Summer 1985, pp. 5-17; Pollock and Pollock, 1986, p. 24; R. Peterson and J. Schulman, "Entrepreneurs and Bank Lending in Canada", Journal of Small Business and Entrepreneurship, Fall 1987; A.J. Riding and D.M. Short, "Some Investor and Entrepreneur Perspectives on the Informal Market for Risk Capital", Journal of Small Business and Entrepreneurship, Fall 1987, pp. 19-30.

# CHAPTER 3: SUPPLY OF EQUITY CAPITAL

## 3.1 Existing Sources of Equity Capital

There are two formal sources of equity capital in Newfoundland: government and private venture capitalists. Informally, friends, family and business associates have long been a source of capital for small business, especially in the start-up phase. As well, some would argue that banks indirectly supply equity capital when individuals get personal loans for their businesses, but the extent of this is unknown.

### 3.1.1 Equity Capital from Governments

Both the federal and provincial governments have programs to provide equity capital to entrepreneurs. Federal programs are delivered through two federal government agencies: the Federal Business Development Bank (FBDB), and Business Development Centers (BDCs, operated under the Community Futures Program). Newfoundland and Labrador Development Corporation (NLDC), a provincial crown corporation, manages the only formal provincial programs.

Federal Business Development Bank (FBDB)

The FBDB provides equity capital through its Venture Capital Division which is one of the largest sources of venture capital in the country.[1] Most venture capital investments of the bank fall in the $500,000-$750,000 range and are made using the same criteria as private venture capital companies. All regions of the country are eligible for investment, but, to date, the FBDB has made no venture capital investments in Newfoundland. Nationally, the Bank has venture capital investments in all other provinces except Prince Edward Island.

Aside from equity investments through its Venture Capital Division, there is some provision for direct equity financing through the FBDB but there is no formal program or active promotion of this service. It has been used in some cases in Newfoundland, mostly in conjunction with term lending, but it appears that the Bank can find few opportunities where equity participation arrangements are acceptable to clients. However, the Bank is very active in the areas of term lending and information and management services.[2]

Business Development Centers (BDCs)

Under the Canadian Jobs Strategy of the federal government, BDCs can be established to support new and expanding small businesses in Community Futures Areas. These BDCs are the successors to Local Economic Development Assistance (LEDA) programs and Local Employment Assistance and Development (LEAD) agencies. They administer investment funds to create employment through support to local business in the form of loans, loan guarantees and equity participation. They also have the capacity to provide counselling to small businesses.

Total financial assistance to any one business cannot exceed $75,000, and to November 1987, the maximum equity participation was $25,000; however, since that time BDCs have been permitted to invest up to $75,000 in the form of equity. This notwithstanding, program officials indicate that almost all equity investments are still within the $25,000 range. The equity participation provision must provide for the buy-back of shares from the BDC at a price that would allow a return on investment at least equal to the commercial rate of interest on the funds invested. Nonetheless, BDCs have most of their investment fund or portfolio in the form of loans.

One of the requirements of eligibility for financing through a BDC is that the entrepreneur's business loan application must have been rejected by commercial lending institutions and the FBDB. Investments are about equally divided between the resource sector (for example, aquaculture, sawmilling), construction and service industries (for example, tourism).

There are five BDCs in Newfoundland covering the following areas:

- Gander (Gander Area Development Corp.)
- Labrador (Labrador Venture Capital Ltd.)
- Stephenville/Port-aux-Basques (Gateway Business Development Centre)
- Central Newfoundland (Exploits LEDA Corp)
- Western Newfoundland (Western Newfoundland Business Corporation)

Newfoundland and Labrador Development Corporation (NLDC)

Two NLDC programs, the Venture Capital Program and the Business Equity Program, supply equity capital to entrepreneurs.

The Venture Capital Program, like similar programs across the country, was developed to encourage the establishment and growth of venture capital companies (VCCs). To be eligible under the program, a VCC must have at least $25,000 in capital and must invest in approved types of local business. NLDC will match the invested capital of registered VCCs to a maximum of $1 million, and a maximum share participation of

49 per cent. At the end of the first year the VCC must have a minimum capital reserve of $50,000 with 40 per cent invested; at the end of the second year, it must have $100,000 with 70 per cent invested. Repayment of NLDC's portion of the capital would begin in year eight for a five-year term at a rate of 1 per cent above the Province of Newfoundland's borrowing rate.

The program was introduced in 1985, but there was effectively no participation until 1987. NLDC officials attribute this to some restrictive program terms which were not modified until 1987, and to a cautious approach by local investors to the idea of venture capital investments. By the end of the fiscal year March 31, 1988, approximately $1.6 million had been approved under the program. Currently, nineteen VCCs are registered and active under the program with average investments of $136,000 per project.[3] All but two of these are project-specific, formed to fund a particular venture as opposed to being pools of capital available for entrepreneurs.

The Business Equity Program was introduced on April 1,1987. It replaced an older program that had a very low participation rate. The new program enables NLDC to take a direct equity position in SMEs of up to 49 per cent through share purchases or shareholders' loans. The program is a matching fund, with NLDC contributing from $10,000 to $250,000 in equity capital. NLDC's capital must be fully repaid by the end of year five, although terms are flexible. The program is open to the manufacturing, processing, tourism and service sectors.

Through the Business Equity Program about $600,000 was invested in the 1987 fiscal year. Although the program can make equity investments as low as $10,000, most investments were at the higher end, with the average investment $150,000. Only about half of the proposed budget for this program was used, but demand is expected to increase as the program becomes more widely known. Nevertheless, it is worth noting that the Business Equity Program made as many investments in its first year of operation as the previous equity financing program did in twelve years of operation.

### 3.1.2 Equity Capital From Private Sources

Venture capital is equity investment in non-publicly traded companies. Although there are differences in the style and approach of venture capital companies (VCCs), some characteristics are constant. A VCC invests in companies at the early to medium growth stage in return for an equity interest. In addition, VCCs generally require a significant role in the management of the company, either at the Board of Directors level or on a day-to-day basis. VCCs generally want a quick payback and high return on investment.

The venture capital industry in Canada has experienced significant growth in recent years: the total pool of capital managed by the industry grew by more than 50 per cent in 1987 to $2.3 billion, and the amount of capital available for investment is close to $1 billion.[4] The main reason for these new capital commitments is the growing number of independent private venture capital firms in Canada. As of 1987, the Association of Canadian Venture Capital Companies (ACVCC) had 60 members with $1.8 million under administration and $346 million invested in Canadian companies. These investments, by region, are as follows: Atlantic--1 per cent; Québec--18 per cent; Ontario--40 per cent; western--26 per cent; and foreign--15 per cent. Based on the activity of its members, the ACVCC estimates that the average term of venture capital investments in Canada is 4.1 years; the average rate of return on investments is 23 per cent before dividends are realized.[5] But this does not represent the full slate of VCC activity in the country. For example, the ACVCC does not include any Newfoundland member, though there is an active, even if small, venture capital community in Newfoundland.

With the exception of the project-specific VCCs referred to earlier, there are only four true VCCs in Newfoundland; two, ResourceCan and Atlantis, are privately-held companies, while the others, NewTel Enterprises and Fortis Inc., are the holding companies for Newfoundland-based utilities.

ResourceCan was formed in 1980 with 20 investors pooling $50,000 each to invest in Newfoundland-based industries. Primary investment areas were ocean industries, specifically fisheries and offshore oil and gas, but their scope now has broadened to include other resource areas and manufacturing. ResourceCan presently has six major investments in Newfoundland, ranging from fish processing to mining and high-tech ventures. Their preferred investment is usually $100,000 with a 40-50 per cent equity position, but this arrangement is flexible.

Atlantis Corp. was formed in 1981 to respond to opportunities related to offshore oil and gas development, although it has diversified its interests since then. Its current investments include a majority interest in a regional airline and interest in several high-tech companies in Newfoundland.

NewTel Enterprises has been in the venture capital business since 1986-87. It is the holding company for the Province's telephone utility, Newfoundland Telephone, and it also has investments in several high-tech firms in Newfoundland. NewTel is primarily interested in investing in areas related to its telecommunications and engineering background. The preferred investment is approximately $500,000 with a major equity position of at least 50 per cent, but all the capital requirements of the venture would be financed, if necessary. NewTel is interested in prospects throughout Atlantic Canada and is not confined to Newfoundland.

Fortis Inc. is the newly created corporate parent of one of the province's major electrical utilities, Newfoundland Light and Power Limited. Although it is intended that Fortis will be involved in venture capital, it has not yet made any investments and is still formulating its investment policy. It appears it will operate in the high end of the venture capital market.

## 3.2 Potential Sources of Equity Capital

### Personal Income and Personal Savings

As shown in Table 1, Newfoundland's per capita income in 1986 was only 68 per cent of the national average; per capita earned income was even lower at 56 per cent of the national average[6]. This discrepancy is because transfer payments are a greater proportion of personal income in Newfoundland (29 per cent) than in Canada (14 per cent). Per capita investment income in 1986, i.e. income from interest, dividends, and other miscellaneous sources,[7] was 37 per cent of Canada's per capita investment income. Most of this investment income comes from dividends from securities. It is estimated that about 5,000 individuals in Newfoundland hold publicly-traded stocks and bonds[8]. These data illustrate that in Newfoundland the availability of significant amounts of equity capital from personal sources will be low.

### Registered Retirement Savings Plans (RRSPs)

For 1985, the most recent data available, total RRSP contributions from Newfoundland amounted to $59 million.[9] Invested through chartered banks, trust and life insurance companies, and securities dealers, this capital flows directly to the country's major financial centres, and from there, it is invested primarily in central Canada and overseas.

### Canada Savings Bonds (CSBs)

Sales of CSBs in Newfoundland have followed the national trend with growth up to 1982, a decline in sales during the recession, followed by increased sales until the 1986/87 series when sales dropped again. In 1985/86 over $123 million in CSBs were sold in Newfoundland; in 1986/87, sales were $78 million.[10] CSBs are administered through the Bank of Canada and these funds flow directly out of Newfoundland.

**TABLE 1: Personal Income and Personal Savings, Newfoundland and Canada, 1969, 1979, 1984, and 1986**

| | $000 Per Capita - Newfoundland | | | | $000 Per Capita Canada | | | | Newfoundland Per Capita as percentage of Canada Per Capita | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1969 | 1979 | 1984 | 1986 | 1969 | 1979 | 1984 | 1986 | 1969 | 1979 | 1984 | 1986 |
| Personal Income | 1.8 | 6.4 | 10.1 | 11.6 | 3.0 | 7.4 | 14.9 | 17.0 | 60.9 | 87.2 | 67.7 | 68.2 |
| Personal Disposable Income | 1.6 | 5.4 | 8.5 | 9.7 | 2.5 | 5.9 | 12.0 | 13.5 | 64.4 | 91.6 | 70.9 | 71.8 |
| Investment Income | 0.1 | 0.3 | 0.7 | 0.8 | 0.2 | 0.6 | 2.0 | 2.3 | 29.7 | 54.2 | 33.7 | 37.0 |
| Personal Savings | -0.05 | 0.2 | 0.2 | -0.1 | 0.1 | 0.7 | 1.8 | 1.6 | -39.2 | 28.9 | 11.3 | -4.2 |

Source: Statistics Canada 13-213, Provincial Economic Accounts — 1961-86, June 1988.

Development Savings Bonds (DSBs)

Newfoundland and Labrador Development Corporation (NLDC) introduced the DSBs by issuing a $10 million series of Development Savings Bonds in October, 1987. These bonds operate in the same way as CSBs but are guaranteed by the Province of Newfoundland. Sales of the bonds reached $9 million and the proceeds were used to support NLDC's financial programs.

Flow-Through Shares

Flow-through shares are a federal tax incentive that provide a tax break for investors and a source of risk capital for mineral exploration activities by allowing non tax-paying exploration companies to transfer deductions for certain exploration expenses to the shareholder. It has been an attractive vehicle across the country and Newfoundland is no exception: it is estimated that $16-18 million was raised in flow-through shares in Newfoundland in 1987.[11] In 1987 the federal government announced changes to the flow-through share provision, reducing the incentive in stages and eventually phasing out the program altogether. However, in May 1988, it announced the new Canadian Exploration Incentive Program (CEIP) which will still provide incentives to qualified companies who can pass them on to shareholders, suggesting that the program will remain an attractive vehicle for Newfoundland investors and Newfoundland capital.

Pension Plan Contributions

There are a number of pension plans in Newfoundland for employees of private companies, governments, crown corporations and labour unions. All of these plans are administered by pension plan managers outside Newfoundland, generally in Toronto or Montréal.

Information on the assets of many private pension plans is not available since plan administrators in Newfoundland are under no obligation to disclose the amounts or destination of those funds. Most of the larger company pension plans are invested in investment (mutual) funds through professional managers, also in Toronto or Montréal. The following is a summary of some of Newfoundland's larger private pension plans as of December 1987, which provide some indication of the value of assets of these plans.

| Company | Total Assets ($ million) | Yearly Contributions ($ million) |
|---|---|---|
| NewTel Enterprises | 65.0 | N/A |
| Fishery Products International | 9.3 | 1.1 |
| Newfoundland Light and Power | 18.8 | 2.4 |
| Memorial University | 131.0 | 4.0 |
| TOTAL | 224.1 | 7.5 |

Pension funds associated with labour unions are held in different ways. For some unions, or for members within unions, pension plans have been negotiated directly with the employer. For example, unionized loggers with Abitibi-Price are part of that company's plan, which is a nation-wide plan for all Abitibi workers and is managed in Montréal. Otherwise, pension funds held directly by the union are individually managed through each union's national or international parent. In both cases, pension plan contributions flow directly out of Newfoundland and are managed as part of larger investment funds.

Most provincial public sector pension funds are part of the Pooled Pension Fund of Newfoundland. This represents about 40,000 people, comprising public servants (including unionized employees), Members of the House of Assembly, School Board employees, hospital workers, employees of post-secondary institutes (except Memorial University of Newfoundland), some Crown Corporation employees, and teachers (although the teachers' plan is kept separate for administrative purposes). The Pooled Pension Fund was set up in 1980 as a separate fund for the purposes of investment; prior to that the fund went into the general revenue of the Government of Newfoundland and Labrador. Total assets of the fund at year end 1987 were $380 million. The most recent financial statements for the fund (1985) show total annual contributions of $71 million. The financial statements also reveal the schedule of investments for the fund. The fund is managed by professional managers in central Canada and is invested in domestic

and foreign stocks (56 per cent), property (5 per cent), fixed income securities (24 per cent), mortgages (4 per cent), and short-term investments (11 per cent).[12]

As in most provinces, there is legislation in Newfoundland (the Pension Benefits Act) that sets certain standards of operation and rules to govern the investment of pension funds. One of these rules, known as the "basket clause", stipulates that the total of unapproved investments may not exceed 7 per cent of the total fund. Unapproved investments can include venture capital projects and investment in SMEs. For the Pooled Pension Plan of the Province of Newfoundland, however, unapproved investments made under the basket clause are in new companies which are considered almost eligible (they do not yet have a full 5-year track record but are not considered risky). Fishery Products International and Falconbridge Metal, for example, fall into this category.

Workers' Compensation Commission ( WCC)

The WCC's investment portfolio comprises mostly bonds (government and company issues); the market value of those investments as of December 31,1987, was $67 million, and as of May 1988, the value of the fund was nearly $100 million.[13] Yearly contributions in 1987 were $15.2 million. Actual yield on the portfolio is now 12.3 per cent. To date, the fund has been managed internally, but its increasing value has prompted the Commission to seek managers from outside the Province as is the case with pension funds generally.

## 3.3 Characteristics of Supply

The following features characterize the supply of equity capital in Newfoundland.

First, there are a limited number of private and public sources of equity capital in the Province. Effectively there are two government agencies (NLDC and BDCs) and three private venture capital companies (Fortis Inc. has not yet made an investment) presently involved in supplying equity capital. There is no depth to the supply because there are very few players actively involved on the supply side, and thus there is limited competition among suppliers.

Another characteristic of supply is that active VCCs are relatively small and do not have the human and capital resources to manage a large number of investments. While officials of VCCs admit that there has been a noticeable increase in the number and quality of business proposals, the size of the VCC community and of the VCCs themselves means they cannot be involved in a large number of investments

at any given time. Additionally, certain proposals, whether good or bad, fall outside their area of business interest.

A third characteristic is that the active VCCs in Newfoundland prefer to make investments in excess of $100,000 but less than $500,000; therefore, they are not active in either the low or high end of the market. While the public sources of equity capital can make investments in the lower range (less than $100,000), in practice these have been limited. For example, as cited earlier, NLDC's average investment under its Business Equity Program is $150,000. In the case of BDCs, the problem is that their equity investments constitute a relatively small percentage of their total investment portfolio (approximately 20 per cent).

Finally, contributions by Newfoundlanders to various savings and investment vehicles suggest that sizeable pools of capital exist. Based on the information collected for this study, which is by no means a comprehensive listing of all capital pools and flows, at least $350 million flows directly out of the Province each year for investment and development elsewhere. As a result, with the exception of some investments in publicly traded Newfoundland stocks and bonds, none of that capital is available to Newfoundland firms.

## Notes

1 Federal Business Development Bank Publication (untitled), Vol.7, No.1, Summer 1987.

2 Newfoundland is FBDB's leading customer in these areas in Atlantic Canada.

3 G. Pearcey, Manager, Policy Research, NLDC, personal communication.

4 Canadian Venture Capital, Vol. 3, No.1, February 1988, p. 14.

5 John Puddington, President, ACVCC, personal communication.

6 Building On Our Strengths, Royal Commission on Employment and Unemployment, 1986. Calculations from Statistics Canada 13-213, p. 396; Newfoundland Statistics Agency.

7 This figure does not include income from non-farm unincorporated businesses; often investment income includes this category.

8 George Courage, Director, Newfoundland Statistics Agency, personal communication.

9 Revenue Canada Taxation, Taxation Statistics, Ottawa, Minister of Supply and Services, 1987.

10 Bank of Canada, Halifax, April 1988.

11 Estimate By R. Smallwood, Manager, Wood Gundy, St. John's, March 1988.

12 Province of Newfoundland Pooled Pension Fund: Financial Statements, Department of the Auditor General , Newfoundland, December 31 1985.

13 Annual Report , Workers' Compensation Commission ,1987; and discussions with WCC executive.

# CHAPTER 4: MECHANISMS TO MOBILIZE EQUITY CAPITAL

## 4.1 Demand Initiatives

The demand side of the market in Newfoundland is presently poorly developed. Efforts must focus on improving the quality and increasing the quantity of demand through a broader and more concerted effort to encourage enterprise. In order to do this, initiatives will have to address both non-financial and financial aspects of the demand problem.

In the non-financial area, measures to improve the quality of demand must focus on business training and counselling services. More specifically, business training and counselling services must be better coordinated, more flexible, more accessible, and, in certain cases, a mandatory condition of government financial assistance.

At present, there are a myriad of government and community-based agencies offering business training and counselling services, but there is little if any coordination among these organizations. Further, there are a large number of course offerings and many types of services available, and a considerable variation in the quality of what is offered. It is both logical and necessary that the federal and provincial governments jointly undertake a comprehensive examination of what they are offering or supporting in business training and counselling services. This review must assess the content and quality of courses and services, mainly to ensure that quality training and counselling are available and well-coordinated.

A recent proposal by NLDC, "The Enterprise Network", may help to coordinate and strengthen the efforts of existing federal and provincial government departments and agencies to provide information and advice to entrepreneurs in all parts of Newfoundland and Labrador. The proposal is currently before the Atlantic Canada Opportunities Agency (ACOA) for funding. As proposed, the Network would be a "first-stop" source of support for entrepreneurs. It would provide access to comprehensive information and advice on government programs, sources of financing, markets, research and development, and other related topics, and could be used for training as well. The Enterprise Network would accomplish this through cooperative links with all agencies and institutions in Newfoundland that deal with small business.[1] This concept could partially address the need for better coordination.

Business training and counselling services must also be made more flexible and accessible. The kind and amount of training needed will vary. Young people and students may require longer-term training like that which is offered at community colleges and Memorial University of Newfoundland, whereas people who are already in business may need shorter, more practical courses at night or on weekends. In addition, the

medium used to deliver materials could be traditional classroom lectures, videos for home use, audio cassettes, or teleconferencing. Regardless, flexibility in course offerings, content, medium and timing is necessary, and this should be reviewed as part of the effort to improve coordination. As well, the related issue of accessibility must be addressed at the same time. For example, there appears to be a growing interest in entrepreneurship among young people in Newfoundland. This would suggest that courses like the "Small Business Entrepreneurial Studies" program at Western Community College should be offered at other community colleges, or that the Faculty of Business Administration at Memorial University be expanded. If people who are already in business are to benefit, they must have local access to training and counselling; delivery could vary from having someone physically present to a computer network.

The most controversial non-financial measure to improve the quality of demand is making it a condition, when needed, of government financial assistance. More specifically, if applicants do not have management skills or business experience themselves or on their staffs, a program of either training or counselling should be a mandatory condition of assistance. By making training or counselling a requirement for assistance in these instances, the applicant would have a better chance of having an application approved because the lending or granting agency would have more confidence in the applicant's potential for success.

While these are non-financial measures to improve the quality of the demand side, the quantity of the demand side can be increased through non-financial measures as well. In the short-term, the principles of entrepreneurship should be included in all programs at the Province's technical schools and community colleges, and should be available at Memorial University of Newfoundland. In the long-term, the Province's school system should also introduce students to the principles of entrepreneurship and the option to take a course in this area.

In the financial area, measures to improve the quality and the quantity of the demand side are relatively simple. The focus must be on providing small amounts of capital to assist business people to conduct feasibility studies and prepare business plans.

These measures should improve the quality and quantity of the demand side. This should translate into a more sophisticated and, by implication, a more successful demand for equity capital in the market. In turn, this should increase and strengthen the Province's private sector and lead to economic diversification and expansion.

## 4.2 Supply Initiatives

Supply initiatives must focus on redirecting government-sponsored equity programs to satisfying demand at the low end of the equity market. Efforts must also stem the flow of capital from the Province by providing investors with the option and incentive to invest in local enterprises. While such initiatives may cause slight market distortions in terms of increased risk or reduced capital mobility, they are necessary in the present underdevloped market. Additionally, the provincial government should look at making more creative use of the Pooled Pension Fund of the Province of Newfoundland by incorporating economic development as a formal objective of its pension fund. Community-based development corporations must be encouraged to more actively support local enterprises through the use of local investment funds. Finally, the private sector in the Province can play a more active role in encouraging entrepreneurship and supporting local enterprises, as in other countries and provinces.

### 4.2.1 Government-Sponsored Equity Programs

Most demand for equity capital in Newfoundland is limited to firms seeking less than $100,000. These are often of little interest to the venture-capital community because such firms lack business skills and experience, and because they want relatively small amounts of capital. For example, for a private venture capitalist, the costs associated with assessing and administering a $50,000 investment are not very different from those associated with a $500,000 investment. For these reasons venture capitalists are not really suited to assist SMEs. To some degree, governments have moved to fill the supply gap in this area. As detailed earlier, the provincial government is involved in this area through NLDC, and the federal government is involved through the BDCs. Another federal agency, FBDB, is proposing to enter this area with a concept called a participating debenture, and the Atlantic Canada Opportunities Agency (ACOA) is also assessing the equity question. However, at present, neither government is satisfying the demand at the low end of the market.

As stated earlier, NLDC's Business Equity Program is only one year old and has an average equity investment of $150,000. This is high given that the program can make equity investments as low as $10,000. Officials of the Corporation attribute this to a combination of factors: in cases with proposals for smaller amounts of capital, management skills are generally unsophisticated and the entrepreneur is often resistant to diluting ownership, or having government involvement in the business. It is also apparent from discussions with Corporation officials that NLDC's review process is no less rigorous than that employed by the private sector. In many respects then, NLDC's program is no different from any other player in the private sector venture capital market; NLDC cannot afford an above average number of losses.[2]

However, NLDC's financial statements reveal it is "managing" a fund of federal government money that has not been used since the federal government withdrew its interest in NLDC in 1984. The fund's $24.5 million has not been committed to any specific use.

Business Development Centres (BDCs) under the federal Community Futures program are active in five regions of the Province and can provide equity capital to businesses. One of the benefits of a BDC is that it can provide quick turnaround on a business proposal because decisions are made at the local level. While BDCs have the potential to make an important contribution to business development in the Province, certain conditions of their operation appear to constrain their effectiveness as a source of equity capital for entrepreneurs. At least three factors appear to limit their potential.

First, if the BDC takes an equity position in a business, there must be an agreement that provides for the buy-back of shares from the BDC at a price that would allow a return on investment at least equal to the commercial rate of interest on the funds invested. In this context, the equity is effectively a loan. While program officials indicated that, generally, the equity would not be withdrawn until the business can afford to repay it, the objective nevertheless is to recover the money as quickly as possible. This is because BDCs have to become self-sufficient in approximately five years. Under these circumstances there is pressure on the BDCs which may force them to request a return of their equity too quickly, or which may force them to place more of their funds in the form of loans at the expense of clients who are seeking equity.

Secondly, there is a requirement that people coming to a BDC for financial assistance must have been rejected by FBDB and other lending institutions. This creates a fundamentally negative image of the role of BDCs as a tool for business and economic development. Instead, BDCs should be a pro-active and positive force in business development, and any regulations which counter this role, such as the one cited above, should be changed.

Thirdly, the *raison d'être* of BDCs (under the Canadian Jobs Strategy) is job creation, and this is a priority in assessing business proposals. On occasion, this may override other considerations.

The dilemma of how to supply equity at the low end of the market has also been of concern to FBDB and ACOA. In the case of FBDB, they have proposed a mechanism known as a participating debenture, based on a successful program in the U.K. This proposal is presently before the federal government for funding consideration. The debenture would operate by lending money to a business, with no repayment until the business reaches the break-even point. Repayment would then begin with a royalty or interest payment adjusted to reflect the risk associated with the investment. The debenture would be flexible, providing

capital to the business in return for a claim on earnings rather than on assets. In this way, there is no dilution of ownership as with true equity, and no onerous debt.

A mechanism that can address deficiencies in both demand and supply is the the most appropriate response to the problem facing SMEs seeking equity at the low end of the market. An excellent model for this approach is Innovations Ontario Corporation (IOC) which was established in 1986 to assist in the development of young technology-driven enterprises in Ontario.[3] On the supply side, it provides pre-venture and other early-stage financing to a maximum of $250,000. The objective is to make recipient businesses more attractive candidates for private sector funding: IOC's role is to complement the private sector and provide financial counselling to entrepreneurs and investors.

This approach has obvious merits for Newfoundland:

- it offers financial and management counselling which would help to improve the quality of the demand side;
- it is directed at start-ups with relatively small financial requirements ;
- it is designed to make businesses more attractive candidates for private-sector financing, complementing, rather than competing with, the private sector.

### 4.2.2 Venture Capital

Venture capital is the most important source of business financing for companies too small to access the public equity markets but needing capital. Two features that characterize the venture capital industry, in general, have important implications for the Newfoundland situation. First, venture capitalists like to make investments in locations they can visit and monitor regularly. As a result, the large and growing number of VCCs in central Canada are not accessible to Newfoundland entrepreneurs. Secondly, the venture capital business is a very personal business; there must be compatibility between investor and entrepreneur since the two must work closely together.

The implications of this are two-fold: VCCs must be indigenous if they are to give the necessary attention and consideration to a proposal; and, there needs to be a larger pool of VCCs in Newfoundland in order to provide a higher probability of realizing a successful deal.

Almost all provinces, Newfoundland included, have programs or incentives to encourage the supply of venture capital, and most are modelled on Ontario's Small Business Development Corporation (SBDC) program which was established in 1979.[4] Under the SBDC program, investors receive grants or individual tax credits for corporations for investing in small business in Ontario. The grant or tax credit

amounts to 30 per cent of the participant's equity involvement in the SBDC. The incentive is recaptured by the government when the SDBC is dissolved.[5] In its eight years of operation, the program triggered $355 million of private investment into small business in Ontario.[6]

By comparison, there was no participation in Newfoundland's Venture Capital Program in its first two years. In 1987, its third year, there were 19 companies registered. For the third year, ending March 31, 1988, NLDC invested $1.5 million in VCCs registered under its program; it is estimated that this triggered $2.5 million in private investment.[7] Two million dollars is budgeted for this program for 1988/89.

Several factors may account for the low interest in NLDC's program when it was introduced in 1985. First, prior to April 1987 service industries and some other sectors were not considered eligible under the program, thereby restricting investments. A second factor may have been that venture capital is a relatively new product in Newfoundland and needs time to develop a market. A third factor may have been that the program did not involve tax credits as an investment incentive as do the programs of most other provinces.[8] This problem was remedied when the provincial government announced, on May 24,1988, a new Venture Capital Tax Credit Program as an additional venture capital program and a complement to the Newfoundland Stock Savings Plan which was introduced at the same time. Investors in VCCs will receive a tax credit against Newfoundland personal income tax payable equal to 30 per cent of their investment and a cash grant of a further 20 per cent up to a maximum of $5000.00 per year. The high income tax rate in Newfoundland suggests that a tax credit and grant scheme could have a broad appeal. As shown in Chapter 3, Newfoundland residents have made considerable contributions to programs offering tax incentives.

Another problem with NLDC's Venture Capital Program is that all but two of the registered VCCs are project specific. In NLDC's program, minimum capital investments are specified to encourage VCCs to make more than one investment. In practice, these limits are being met with the first, and only, investment.[9] Aside from this capital requirement, there are no other regulations to encourage other investments by the VCC. This problem was also encountered with the SBDC program, determined through an empirical survey of over 300 SBDCs in 1984.[10] A recommendation of that study was that the regulations be changed so that new and existing SBDCs continually promote and evaluate new investments, thereby functioning as a true venture capital company.

### 4.2.3 Stock Savings Plans

Stock Savings Plans (SSPs) are tax-based incentives designed to encourage direct equity investment in business. The investor is normally allowed to use a portion of the amount invested either as a deduction against taxable income or as a credit against tax payable. The SSPs are provincial government initiatives, implemented with federal government assistance and cooperation.

Québec's SSP, introduced in 1978, was the first of its kind in Canada. Today, there are SSPs in Alberta, Saskatchewan and Nova Scotia, and other provinces are considering initiating their own plans. A Bill to enact the Newfoundland Stock Savings Plan (NSSP) was introduced in the provincial legislature on May 24, 1988. The intent of the NSSP is to increase the equity capitalization of SMEs in the Province, particularly those requiring an infusion of investment funds to finance growth, and to encourage Newfoundland residents to make direct equity investments in Newfoundland businesses.

The experience of the Québec SSP suggests there may be several important benefits of a stock savings plan for this Province. The following have been cited as benefits to Québec from the SSP:[11]

- companies requiring funds, but not normally having access to public markets, have been able to access public investment funds;
- in many instances capital structures were strengthened and businesses were able to finance expansion;
- financed expansion resulted in increased levels of economic activity and the creation of new job opportunities;
- the public's knowledge of economic issues increased, and a heightened awareness of the importance of entrepreneurship was realized;
- the business climate and the entrepreneurial spirit in the province were revitalized.

The QSSP has not been without its critics, however, and it has changed over the years in response to its increasing cost to government and changing economic conditions. Nevertheless, even its critics agree that, overall, the plan has helped Québec companies to access equity capital and has contributed to economic development in that province.

In the same way, the NSSP can be of particular use to businesses in Newfoundland that have been constrained in realizing their growth potential as a result of insufficient equity in their capital structures. The NSSP will also provide entrepreneurs with an alternative to debt financing as a source of investment funds. Eligible businesses can apply for a subsidy to offset the costs of issuing an initial public offering.

Government will provide a subsidy of 50 per cent of certain costs of preparing the first issue, to a maximum of $50,000.

The tax credit available to the investor under the NSSP will range from 10 to 30 per cent of the investment, to a maximum annual investment per investor of $10,000, including any investment made under the Venture Capital Tax Credit Program. Four categories of companies have been defined, with the tax credit rate based upon the value of assets and sales: the lower tax credit will apply to senior and mature companies listed on a stock exchange and the maximum tax credit will be available to investors in expanding and emerging companies which are publicly traded but not listed on a stock exchange. As an added incentive to invest in the latter types of companies, government will provide a cash grant equal to a further 20 per cent of an individual's investment.

While the NSSP has potential for a broad range of companies seeking capital, it will be particularly beneficial to those companies, such as the growing high-tech firms described earlier, which are looking for larger amounts of capital. Investors now have an added incentive to invest in these companies.

### 4.2.4 Pension Funds

In 1987, pension funds represented one of the largest pools of capital in the country, with total assets between $330 billion and $350 billion.[12] Most of this is invested in publicly traded stocks and bonds. In 1984, the last year for which information is available, there were 4.5 million members of pension plans in Canada; Newfoundland's share was 68,080 members, or 1.5 per cent of the national total.[13] About 40,000 of the Newfoundland members belong to a single plan, the Pooled Pension Plan of the Province of Newfoundland. Public and private pension plans in Newfoundland are managed by professional fund managers from outside the Province.

Nationally, there has been an increase in the use of pension funds for venture capital investment, especially since the introduction of tax incentives in the Federal Government's 1985 budget. Nevertheless, one of the major obstacles to the increased use of pension money to help SMEs is the attitude of the fund sponsors or their investment managers.[14] The effect of this is amplified in Newfoundland for two reasons: first, plan administrators have never issued a specific directive to fund managers to invest in SMEs in Newfoundland;[15] and second, all pension money is invested through professional managers in central Canada. If these individuals are cautious in making venture capital investments in central Canada, they would probably be highly averse to investing in regions with which

they are unfamiliar. Consequently, it is important to identify mechanisms to retain some of this pension money in Newfoundland, and to direct it to businesses and economic development in the Province.

Existing Incentives

In 1985 the Government of Canada created three vehicles to attract venture capital from pension funds through tax incentives: Small Business Investment Corporations (SBICs); Small Business Investment Limited Partnerships (SBILPs); and Small Business Investment Trusts (SBITs). For every dollar invested by a pension fund in small business through one of these venture capital vehicles there will be a three-dollar expansion of the foreign property limit of the fund's investment portfolio.[16] Various regulations govern the different vehicles, but in the case of a SBIC, a pension plan may own 100 per cent of an SBIC which would then invest in eligible companies. It is interesting that under the rules which govern this program, eligible corporations include VCCs set up under provincial programs, although provincially incorporated VCCs in the Atlantic region are not specifically prescribed.[17] This may be because provincial venture capital programs were just being established in this region at that time, but the situation has since changed. Under NLDC's Venture Capital Program, pension funds are not indicated as either eligible or ineligible investors in a VCC. The only condition is that 20 per cent of the shares of a VCC must be held by an individual; pension funds are not precluded from holding the remaining 80 per cent, or any lesser percentage thereof.

There is no means of gauging how effective this set of federal tax incentives has been in directing pension money to venture capital: no data are available on total investments, the number of funds that have such investments, or on the location of venture investments made using one of these vehicles. From available information on investments of pension plans from Newfoundland, there is no indication that any of them have been used for venture capital through any of the vehicles described above.

Mechanisms Employed in Other Provinces

In Canada, Québec is the undisputed leader in the use of pension funds for venture capital investment. The investments are made through the Caisse de Depot et Placement du Québec, established in 1965. The Caisse has two objectives: to seek a profitable return on its investments and to support economic development in Québec. Major depositors in the Caisse include the Québec Pension Plan, the provincial auto insurance plan, and the Workers' Compensation Commission, as well as other smaller insurance and pension funds.[18] Investments of the Caisse follow a pattern similar to most pension funds, with the exception that among its investments, as of 1986, are $125 million in share purchase of, and $100 million in loans to, medium-sized enterprises in Québec.[19] There have been some suggestions that the two objectives of the Caisse are in potential conflict with one another, but the Caisse has become a major

instrument of economic development in the province, and over the past eight years has had a rate of return on investment of about 14 per cent.[20]

Investments through the Caisse can be made before, during, or after the listing of a company's shares on the stock exchange. Newfoundland pension funds, like those in Québec, could be invested in local businesses in conjunction with a stock savings plan. This would be an innovative use of Newfoundland pension funds and would promote the NSSP.

A mechanism such as the Caisse or the application of the basket clause provision of any pension fund raises the issue of separating political considerations from investment decisions. This is of particular concern in a small province like Newfoundland, and administrators of the provincial pension plan give this as a reason for avoiding these sorts of investments to date. There does not seem to be an easy answer to this dilemma: Québec decided that the benefits of using pension and other funds for development purposes outweighed a concern over political abuse. The fact that similar objectives have also been employed successfully by state governments in the U.S suggests there are means of minimizing such problems.

The findings and recommendations of the 1987 Ontario Task Force on the Investment of Public Sector Pension Funds[21] proposed that instead of the basket clause and other caveats, pension fund investment in general should be governed by the "prudent person approach" - that investment decisions be based on any objectives, including ethical or moral considerations, as long as the standard of "prudence" is met in the overall portfolio. This signals a definite shift in the traditional view of how pension funds should be invested.

The experiences of other jurisdictions, in the United States in particular, suggest that the impact of this type of activity could be significant. The state of Michigan, for example, established a venture capital program in 1981 to allow for the investment of up to five per cent of the pension fund assets of state employees. A regional venture capital pool was also established to manage investments from other pension funds, insurance companies and endowments. The result of this and other initiatives in the venture capital area was the creation of an environment conducive to the development of young, growing firms, especially in the areas of computer technology, electronics and engineering.[22] These examples and trends suggest that Newfoundland could also incorporate an economic development objective in the management of its public sector pension fund. Seven per cent of the yearly contributions to the Pooled Pension Plan of the Province of Newfoundland would be about $5 million annually, and this could be made available for economic development. While this is the largest single fund, there are others that are potential contributors.

A New Mechanism

The findings of the Ontario Task Force and the experience of the Caisse in Québec indicate that non-traditional investments or investments based on objectives of economic development are legitimate and acceptable activities of pension funds as long as they can be shown to be prudent. A recent proposal from a Toronto-based investment company suggests that investments can be made in a portfolio of Atlantic Canadian companies, not only without being imprudent, but in a way which allows a higher return on investment than would be expected from a traditional investment of pension funds in securities.

To this end, First Canadian Capital Management Incorporated recently established the Atlantic Canada Investment Trust to provide direct investments in securities of organizations based in the Atlantic Provinces. Specifically, 100 per cent of the Trust's assets will be in securities issued in the Provinces of Newfoundland, Nova Scotia, New Brunswick and Prince Edward Island, and in corporations listed on the Toronto and Montréal Stock Exchanges which have head offices in the Atlantic Provinces. The Trust is the first such regional investment vehicle in this country.

One of the appeals of the Trust is that it spreads its investments among a variety of Atlantic Canada securities, and investments cannot be directed for any reason other than capitalization. This removes the concern that political considerations could find their way into investment decisions.

### 4.2.5 Labour-Sponsored Investment Funds

As with pension funds in general, there has been increasing interest in the investment for venture capital purposes of pension and other funds owned by organized labour. Many are coming to believe that labour-sponsored venture capital funds have the potential to maintain and create jobs and allow workers to participate in economic development. To date, the Québec Federation of Labour's Solidarity Fund is the only such fund in Canada. Recent information on the Fund demonstrates its progress since its creation four years ago.[23] It has over $180 million in assets and over 65,000 shareholders; its investments in 40 SMEs in Québec have maintained more than 6,000 jobs. The Fund is registered as a VCC and is an eligible investment for SBICs, SBILPs and SBITs. Individual investors receive a federal-provincial tax credit worth up to $1,400 and a further 40 per cent in deferred tax when they register their shares in an RRSP.[24]

To encourage the creation of more groups like the Solidarity Fund, the federal government has, through its 1985 and 1988 budgets, introduced tax measures to encourage such investments by organized labour. The 1985 measures included a new tax credit to encourage individuals to invest in labour-

sponsored organizations, but the organizations had to be provincially based and the funds co-sponsored by provincial governments. No new organizations were established to take advantage of the incentive. The 1988 budget changed the rules so that now Canadians investing in national venture capital funds sponsored by labour organizations can earn federal tax credits. This new incentive prompted the Canadian Federation of Labour (CFL) to set up a venture capital corporation, Working Ventures, that is now at the preliminary stages of incorporation. Working Ventures will sell shares to workers and use the money to invest in businesses with growth potential.[25] Under the new federal incentive, individuals who invest will be eligible for a tax credit of 20 per cent of the cost of the shares up to a maximum credit of $700. The CFL is also seeking support from provincial governments for a matching tax credit of 20 per cent.

Union members affiliated with the CFL, as well as outsiders, will be eligible to invest in the fund, the first venture capital fund sponsored by a national labour organization. Plans sponsored by other national bodies do not appear imminent: apparently there is continuing debate within the Canadian Labour Congress (CLC) about whether workers should become involved with owning pools of capital because it could lead labour unions away from their prime purposes.[26]

One attraction of the new CFL proposal for workers in Newfoundland is that contributions to the fund can be separate from their pension plan contributions. Under the CFL proposal, workers could make separate contributions and receive the tax credit and additional tax breaks without their existing pension commitments being affected. There is no mention of a regional component to the new proposal, so it is difficult to determine whether any of the money would go to assist businesses in Newfoundland. The record of other national and central Canadian venture capital investments, however, suggests that little, if any, would be invested in Newfoundland. Because of this trend, it would be beneficial for the provincial government to provide a matching tax credit for investments in Newfoundland businesses. There has been no effort by labour groups in Newfoundland to set up a Newfoundland-based, labour-sponsored fund, mostly because pension funds are presently committed to outside plans. The profusion of plans makes it difficult to determine how much pension money is invested outside the Province, but this task is also hampered by the lack of disclosure requirements for private sector pension plans in Newfoundland. Members of these plans are often not aware of the extent or nature of investments made through their pension fund.

### 4.2.6 Community-Based Venture Capital

This study has concentrated on mobilizing capital at the provincial level. However, there is another dimension that must be addressed: the accumulation of capital at the community level, managed through community-based groups, for investment in local enterprises. Community groups are important as a source of knowledge of local opportunities and local needs.

Entrepreneurs in rural Newfoundland presently have access to equity capital through programs offered by NLDC around the Province. As well, the five BDCs located throughout the Province can supply equity capital to local entrepreneurs. But all this money is government money. There are no organizations in this province, excepting co-operatives, which presently invest capital from the community in enterprises in the community.

Community-based investment in local enterprises has been slow to develop in Newfoundland. This situation is related to a failure to promote entrepreneurship as well as negative attitudes to business, based on past experience. This has probably been exacerbated by a latent feeling that governments are a ready source of capital, especially in the form of grants. Nevertheless, there is encouraging evidence that these attitudes are changing. Increasingly, people are beginning to accept the important role of enterprise in the economy. For example, the recently-formed Great Northern Peninsula Development Corporation has a very broad mandate to research, plan, promote and implement self-sustaining business enterprises on the Great Northern Peninsula, including White Bay and the Labrador Straits.[27] It has included as part of its mandate the provision of investment capital although it has not made any investments to date, nor has it indicated where the capital will come from.

The GNPDC and others like it could raise additional capital through programs such as NLDC's Venture Capital Program or through the Venture Capital Tax Credit Program. If this new approach is to succeed, a critical feature of the investment strategy is that some of the capital must come from individuals in the community. This would ensure that people have a genuine and vested interest in locally-based businesses that is often missing when ventures are financed through government grants. Successful experiences of this type are the most effective way community development corporations can earn the credibility necessary to attract other local investors.

Other potential players in providing services to local entrepreneurs are credit unions and co-operatives. Credit unions, in particular, are one of the few organizations expanding into rural Newfoundland: six new rural credit unions have been established over the past three years. Although they presently handle only

consumer loans, some have indicated their desire to expand into commercial lending and equity investments.[28]

Private Sector Initiatives at a Local Level

There have been no major initiatives involving the cooperation of the private sector and locally based organizations to assist entrepreneurs in this province. Yet there have been interesting developments in recent years in other jurisdictions involving the secondment or provision of technical and managerial assistance from large companies to assist local business people or the local community. Both the United Kingdom and Québec provide interesting models for such cooperation. In the United Kingdom, for example, "Business in the Community" is a private-sector-funded organization, staffed by people seconded from companies active in a particular region, to promote the involvement of those companies in stimulating the economic prosperity of local communities. It sets up and supports independent local Enterprise Agencies in partnership with the public sector and other organizations. These Agencies provide a range of services, including free advice and counselling, workshops, training and matchmaking. Private-sector support can be in the form of financial assistance, seconded staff, or advice to clients.[29]

The private sector initiative in Québec, the Societé en Commandité de Création d'Enterprises (SOCCRENT), is active in the Saguenay/Lac-St-Jean region. It identifies opportunities for local business, often starting with an examination of the purchasing habits of large companies in the region, and then providing management support for local entrepreneurs to take advantage of opportunities. In addition to the provision of management expertise through SOCCRENT, large companies in the region, such as Alcan, Abitibi-Price, and Cascades Paper, have contributed funds as a source of start-up capital for new businesses.[30]

There have been no private-sector initiatives of this nature in Newfoundland. While there are understandable obstacles to providing start-up capital to entrepreneurs, the provision of management advice or workshops in cooperation with local organizations appears to be a reasonable proposition for large companies which are active in the Province. These initiatives are good examples of co-operation between the private sector and local organizations that require no government intervention, but would be an effective mechanism to support SMEs in Newfoundland.

## Notes

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1 Proposal for the establishment of the Enterprise Network. Presented to the Atlantic Canada Opportunities Agency by the Newfoundland and Labrador Development Corporation Limited, March, 1988.

2 Ibid.

3 Innovation Ontario Corporation, Canadian Venture Capital Magazine, Vol. 3, No. 1, February 1988. Other provinces also have provincially owned or sponsored venture funds which, like IOC, are designed specifically to back early-stage financing requirements. These include Discovery Enterprises Inc. in British Colombia, VenCap Equities in Alberta, and Sodeq in Québec.

4 Other provincial programs include: Quebec Societés de Development de l'Entreprise Québecoise (SODEQ); Venture Capital Corporations (VCCs) in Nova Scotia, Manitoba, Prince Edward Island and Saskatchewan; Alberta's Small Business Equity Program; and British Colombia's Small Business Venture Capital Corps.

5 R.M. Knight and W.K. Ferguson, "The Success of Canada's SBDC Program", Working Paper Series No.84-12, School of Business Administration, The University of Western Ontario, March 1984.

6 NLDC Summary Data, 1988.

7 M.A. Prychoda, "Equity Programs Work With Good Advice", Small Business Magazine, March 1988, p. 60.

8 Newfoundland and three other provinces offer something other than a tax credit: Manitoba's program contributes 35 percent of invested capital; programs in New Brunswick and Nova Scotia involve investor loans. All the other programs in Ontario, British Colombia, Alberta, Quebec and Saskatchewan offer tax credits or grants.

9 Gail Pearcey, NLDC, personal interview.

10 Knight and Ferguson, 1984.

11 Jean-Pierre De Montigny, "Québec's Experience with Stock Savings Plans", A Presentation to The Conference Board of Canada's Atlantic Business Outlook Conference, March 3, 1988.

12 E.T. Jackson, "Mobilizing Capital for Regional Development", Economic Council of Canada, November 1987.

13 Statistics Canada, Table 4, 1986a, p. 64.

14 M. MacDonald and J. Perry, Pension Funds and Venture Capital, Science Council of Canada Discussion Paper, September 1985.

15 This was confirmed by administrators for the Province's Pooled Pension Plan, and there is no evidence of non-traditional investments by any of the other plans.

16 See note 3.

17 Ibid, p. 42.

18 Ibid, p. 47.

19 Ibid, p. 46.

20 See for example: J.E. Pesando, "An economic analysis of government investment corporations, with attention to the Caisse de Depot et Placement du Québec and the Alberta Heritage Fund", Economic Council of Canada Discussion Paper No. 277, 1986.

21 Province of Ontario, 1987. In Whose Interest? Report of the Task Force on the Investment of Public Sector Pension Funds, Ontario, 1987.

22 MacDonald and Perry, 1985; and E.T. Jackson, "Mobilizing Capital for Regional Development", Economic Council of Canada, Ottawa, 1987.

23 Remarks by the Honourable Pierre H. Cadieux, Minister of Labour, Extract from Hansard, House of Commons Debate on the Budget, February 11 1988.

24 Jackson, 1987, p. 50.

25 The Globe and Mail, March 7 1988, p. B9.

26 The Ottawa Citizen, March 9 1988, p. C11.

27 Newsletter, Great Northern Peninsula Development Corporation, Vol.1, No.1, December 1987.

28 Richard Fuchs, Director of Research and Analysis, Department of Rural and Agriculture and Northern Development, personal communication.

29 Business in the Community, 227a City Road, London, EC1V1LX. Telephone 01-253 3716.

30 "Funding For Startups", Invest Canada, Fall 1986, p. 18.

# CHAPTER 5: CONCLUSIONS

While quantitative information on the need for equity capital in Newfoundland is scanty, it is widely recognizedt hat a strengthening of the equity base of new and existing companies is required. At present, the market for equity capital is small. There are at least two reasons for this: (1) the economy is vulnerable and dependent, which makes it difficult to attract or retain investment, and (2) most businesses in the Province are small, owner-operated establishments in the service sector and, therefore, have limited experience with shared ownership and a low need and appreciation of the role of outside equity. Consequently, demand for equity is limited to a small but growing sector of the business community. More specifically, market demand can be classified at present to include: (1) a small percentage of new and existing under-capitalized companies, and (2) new and emerging high-technology services and product manufacturing companies, which represent an even smaller percentage of the business community. While those who need equity but do not come to the market will not succeed in obtaining it, even those who do come to the market are often unsuccessful. This is because those who need and/or demand equity capital often lack a well-defined business plan, associated management skills and business experience, and an understanding of the role of equity in an enterprise. Yet there are others with the required skills and experience who, because of differences with suppliers about the amount of capital being sought and/or area of business interest, are often unsuccessful as well.

The fundamental problem with supply is that supplies are limited to a few public and private sources at present. While this should come as no surprise given the present state of demand in the Province, it is a serious problem for a number of reasons. First, there is effectively no competition among suppliers. The experiences of other provinces demonstrate that, to be effective, the available pools of capital should be large and the sources, or venture capitalists, should be both numerous and indigenous to the respective regions. Secondly, the local venture-capital community cannot manage a large number of projects or investments, simply because they do not have the resources to do so. Thirdly, there are often incompatibilities between those with capital and those seeking it. The biggest problem in this regard is that firms without experienced management are, understandably, of little interest to the the private sector. However, there are other factors which result in incompatibilities as well. For example, most firms in the Province are looking for relatively small amounts of capital, i.e. less than $100,000.00, whereas most venture capital companies want to make larger investments. Or the amount of capital being sought may be too large for the local venture capital community to supply, as in some high-tech ventures. Another factor which can produce incompatibility is differing areas of business interest. For example, some local venture capital companies have decided to limit their areas of interest to a few sectors, and if they are approached by someone with a project that falls outside these sectors, regardless of how good the proposal is, there will be no deal.

At present, the demand side of the equation is generally very weak and poorly developed in Newfoundland and, consequently, considerable effort must now be directed to improving the quality and increasing the quantity of the demand side. Neither government nor private sources are fully meeting the supply needs of local companies. Many of those who need capital are of little interest to the private sector, not only because they lack the appropriate skills and experience, but because they are looking for relatively small amounts of capital. Companies with these characteristics require management training and counselling, and more liberal and generous access to public equity financing than would be available through the private sector, until such time as they reach a level of maturity where they are attractive to the private venture-capital market. The federal and provincial governments should target the low end of the market, i.e. less than $100,000.00, and not compete with the private-sector venture-capital community.

At the same time, efforts must focus on increasing the number of indigenous venture capitalists and sources of supply, particularly because the existing market is unable to meet the requirements of some local companies who need relatively larger amounts of capital. Ironically, there are large pools of capital in various savings and investments, almost all of which flows out of the Province. Some of this money, the total of which is at least $350 million a year, must be tapped and directed to economic development. This can be done in two ways. First, mechanisms must be made available that provide those with capital the option and incentive to invest in local enterprises. Secondly, some of this money should be used by governments to finance measures which address some of these fundamental problems of demand and supply.

All of these measures must recognize that efforts to encourage demand and build an indigenous supply of capital are for the purpose of building a favorable environment for entrepreneurs and enterprise. Moreover, the development of appropriate mechanisms must be based on a commitment to the private sector and a belief that a strengthening of SMEs will result in economic diversification and expansion.

## APPENDIX A:
## ECONOMIC COUNCIL OF NEWFOUNDLAND AND LABRADOR RECOMMENDATIONS

The following recommendations are based on an analysis of the existing market for equity capital and an examination of mechanisms to stimulate demand and supply.

Demand Related

In order to improve the quality of the demand side, the following recommendations apply:

1. While there are presently a myriad of business training courses being offered and several agencies providing counselling services, there is a lack of coordination between the federal and provincial governments in the design and delivery of these courses and services. Both governments should review the content and quality of existing courses and services to ensure that they address the full range of needs of entrepreneurs and that they are delivered in a more coordinated manner.

2. Business training and counselling services must be more flexible and accessible. More specifically, there must be flexibility in course offerings, format, content and timing. Courses for young people and students, for example, should be longer term and offered through post-secondary institutes. People who are already in business need shorter, more practical courses.To be effective, these courses and services must be accessible throughout the Province. Delivery can be made in a number of ways, from having instructors on site, to teleconferencing, to the use of a computer network and videos for home use.

3. If applicants do not have adequate management skills or business experience, a program of counselling/training should be a mandatory condition of government financial assistance. This would reduce the risk of the investment to government and increase the entrepreneur's chance of success.

To increase the quantity of demand, the following recommendation applies:

1. The principles of entrepreneurship should be taught and required in all programs in the Province's technical schools and community colleges and should be more widely available for students in programs at Memorial University of Newfoundland. Additionally, the Province's school system should also introduce students to the principles of entrepreneurship and should provide them with the option to take a course in this area.

Supply Related

**Government Programs for Equity Capital**

The provincial and federal governments must take a pro-active role in increasing supplies of equity capital to existing and prospective businesses in Newfoundland. Given existing deficiencies on the demand side, programs will have to provide more liberal and generous access to equity financing than is currently available, until these companies mature and are an acceptable risk to the private venture-capital community. Specifically, government programs must address the needs of companies at the low end of the market, i.e. those looking for capital in amounts less than $100,000, so that they complement, rather than compete with, the private sector. In this regard, the following rneasures are recommended:

1. NLDC's Business Equity Program should focus on the low end of the market, and its repayment schedule should be tied to a company's financial position, not to a fixed number of years as at present. Alternatively, the provincial government should introduce a new program to supplement NLDC's current program.

2. BDCs, which have the capability of investing small amounts of equity capital, have a small percentage of equity investments in their portfolio because they are limited by the size of their investment funds and by their operating criteria which require them to be self-sufficient in five years. They should increase the number of equity investments in their portfolios. To do this, either their operating criteria must change and/or their investment funds must increase.

3. FBDB's concept of a Participating Debenture, currently before the federal government for funding, must also be seriously considered as a means of providing this type of equity financing.

4. The Atlantic Canada Opportunities Agency (ACOA) must also consider an equity financing program if they are to address seriously the financing needs of SMEs in Newfoundland .

**Private Equity Capital**

To retain some of the capital which flows out of the Province, mechanisms must be available to provide investors the option and incentive to invest in local enterprises. Tax-based schemes are particularly effective: the newly created Newfoundland Stock Savings Plan and the Venture Capital Tax Credit Program are welcome initiatives in this area. However, other measures can be taken to encourage private capital:

1. To encourage an indigenous pool of venture capitalists, it is recommended that NLDC's Venture Capital Program include a regulation or incentive to encourage registered VCCs to make more than one investment.

2. It is recommended that provincially incorporated VCCs in Atlantic Canada be specifically prescribed as eligible corporations under those federal tax incentives that provide for the use of pension funds for venture capital.

3. The provincial government should consider matching the federal tax credit for labour-sponsored investment funds introduced in the federal government's 1988 budget. This will allow individuals investing in national venture capital funds sponsored by labour organizations to receive an additional tax credit of 20 per cent from the Government of Newfoundland. It is further recommended that such a matching tax credit should be contingent upon investment in Newfoundland businesses.

**Pension Funds and Venture Capital**

1. It is recommended that the Government of Newfoundland incorporate two objectives for its public-sector pension fund: optimizing return on investment and financing economic development initiatives in the Province. It could begin by committing up to 7 per cent of its plan under the existing basket clause provision. This amount, about $5 million annually, could be used to finance the initiatives referred to earlier concerning demand and public-sector equity supply. Furthermore, the government should continuously monitor and review its total investment portfolio with the objective of maximizing investment in Newfoundland-based companies while maintaining a "prudent person" approach to investment.

**Community-Based Initiatives**

1. The shortage of investment funds for community-based corporations can be aided by existing government programs. Development corporations should take advantage of programs such as NLDC's Venture Capital Program or Venture Capital Tax Credit Program which can help generate locally-sourced investment funds.

2. As has been successful in other jurisdictions, notably the U.K. and Québec, a formal mechanism should be established to promote cooperation between community groups and major companies active in a region to foster the development of local enterprises. Examples of this include the secondment of managerial or technical expertise to assist local entrepreneurs, and initiatives in the area of supplier development.

### Information and Data Gathering

An assessment of the market for equity capital in Newfoundland is hampered by the absence of a useable, practical profile of Newfoundland businesses in general and an absence of data on the demand and supply of capital specifically. Therefore, it is recommended that the provincial government undertake a comprehensive, empirical survey of businesses in Newfoundland to obtain basic profile data and to track business performance over time.

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